

## DEPARTMENT OF STATE

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NSC Review Completed.

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File

TO : • OVP - Mrs. Nancy Bearg Dyke  
• NSC - Mr. Allen Lenz  
• DOE - Mr. Henry Thomas  
• DOC - Ms. Jean Jones  
• DOD - Mr. Jay Rixse  
• JCS - LTC Edward Bucknell  
• USTR - Mr. Richard Heimlich  
• Treasury - Mr. David Pickford  
• CIA -   
• OMB - Mr. William Schneider

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SUBJECT: Strategy Paper on Yamal Energy Alternatives

Attached for interagency consideration and comment is a working level draft strategy paper on Yamal energy alternatives as tasked by the SIG on East-West Economic Relations in its meeting October 9. The draft is being circulated in advance of SIG-level clearance owing to the presence of senior officers in Cancun.

Addressees are asked to review the draft promptly. Suggested revisions, in writing, should be sent to this office by COB Monday, October 26. A SIG meeting to discuss the draft will be scheduled for the week of October 26.

*Richard L. Bremer, III*  
L. Paul Bremer, III  
Executive Secretary

Attachment:  
Strategy paper with appendices

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GDS 10/23/87

A US Strategy Towards the West European-Soviet Union Gas PipelineBackground

The ideal European response to the President's concerns about the pipeline would be total abandonment of the Siberian pipeline project. This would effectively reduce European vulnerability to the disruption or threat of disruption of Soviet gas supplies and eliminate the hard currency earnings the project would provide the Soviets.

Given the strong political commitment by European leaders to the project and the progress made in the negotiations to date, the project is expected to proceed. Since President Reagan aired U.S. concerns to European leaders at the July Ottawa Summit, the only critical unresolved issue is price. The Soviets and the Germans hope to conclude the discussions before the November 23-24 Brezhnev visit to Bonn. Agreement is expected to be announced at that time.

A fundamental issue is whether the U.S. can effectively pursue with the allies the development of a coordinated and mutually beneficial strategy for international energy security and East-West trade. Parts of this strategy are in place, but the pipeline raises broader strategic problems which must be considered. The Europeans view the Soviet gas as an important means to diversify their energy supply. Pursuing energy diversification has been an important objective in the IEA and at Economic Summits. However, European economies and political systems will remain vulnerable to Middle East oil disruptions and the pipeline would create still another source of vulnerability. The Europeans must be prepared to minimize the risk resulting from energy disruptions from one or the other or both of these sources.

A second fundamental issue exemplified by this project is the divergence of views on East-West trade between the US and the Europeans. The Europeans believe that trade results in benefits to both sides. The pipeline has wide labor and business support in those participating countries.

~~If the pipeline proceeds despite our strong concerns US objectives should be sixfold:~~

(i) Minimize European vulnerability to Soviet gas disruptions due to technical and/or political reasons;

(ii) Maximize the European options and incentives to achieve a favorable price and set of conditions for the gas;

(iii) Reduce the benefits which would accrue to the Soviet Union;

(iv) Signal that the United States is willing to do its share to strengthen the energy security of the West;

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(v) Take into account the need for Allied and other European support for broader US objectives (e.g. TNF and tighter multilateral export controls); and

(vi) Ensure that any US economic restrictions should hurt Soviet interests more than US interests.

To address U.S. concerns and influence the timing, terms and conditions of the project it is imperative that the U.S. begin discussions with the FRG and other European participants by the first week in November, although at this late stage it may not be possible for the U.S. to prevent the construction of the pipeline. However, we should still continue to voice our basic concerns to the Europeans and, as President Reagan has promised, offer them options for meeting their energy needs.

Strong actions initiated by the United States--like an embargo of equipment needed for the project--~~may~~<sup>probably will</sup> delay construction of the pipeline (and) could reinforce our arguments and their doubts about the need for future increased quantities. Valuable time could be gained--time which can benefit the Europeans in their continuing negotiations with the Soviet Union, as well as provide an important window of opportunity in which to strengthen European defenses against a possible future cut-off of gas supplies. The Europeans, however, may view such a delay as an extension of their vulnerability to Middle East energy. In addition, such a step would exacerbate our political difficulties with European allies and make progress on other high Administration priorities more difficult.

#### Major U.S. Points to be Raised

Achieving the above objectives would require joint action by Western European countries and the United States. In forthcoming discussions with the Europeans, the U.S. should emphasize the following points:

(1) The economic viability of the pipeline is becoming more uncertain. There are growing indications that gas demand will be significantly lower than previously anticipated and that other, less risky energy supplies might be available from elsewhere. We must, however, recognize that while on purely energy grounds the pipeline is becoming less economically attractive, the Europeans see the pipeline as helping to provide jobs and to support key depressed industries within Europe.

The Europeans are trying and may be successful in holding out until the Brezhnev visit to Bonn for a better price and more favorable conditions. This is a point which we should emphasize. Barring renewed conflict and disruption in the Near East, a delay, even beyond the Brezhnev trip, could work to the advantage of the Europeans. The Europeans may oppose a protracted delay, however, since they view the period preceding the Brezhnev visit to Bonn as the best time to complete the deal.

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In the best of circumstances, Europe's gain can be maximized at the expense of the Soviet Union and the objective of reducing the benefits to the Soviets will be partially realized. (Annex I has a detailed discussion of the economic viability of the pipeline.)

(2) In a worst case scenario, Europe would be susceptible to increased political and economic leverage applied by the Soviet Union. Although European reliance on Soviet gas will only account for 5 percent of total energy consumption, some regions and sectors would be far more dependent. In the event of an interruption in Soviet gas supplies, there would be no readily available substitutes unless there was excess capacity in other parts of the gas grid. Unless there is sufficient stored gas and infrastructure to deliver it, gas is difficult to replace on short notice: there is no spot market and storage is expensive and technically difficult.

In the event of a Middle East oil disruption, the Soviet Union would have enhanced leverage which they might exploit. If both the Middle East oil deliveries and Soviet gas imports were disrupted simultaneously, Europe and its Allies would face serious economic, political and strategic difficulties.

(3) Other energy alternatives are available over the medium and longer term that can better serve European economic, security and political interests than the Soviet gas option. Imported coal, nuclear power, and intensified indigenous North Sea oil and gas production could all contribute to meeting future European energy demand and thereby replace the need for Soviet gas (see Annex 3). There are new developments which suggest that the Nigerians may be willing to provide significant quantities of natural gas at competitive prices. (DOE will circulate, shortly, an annex to this paper which goes into detail on this issue.)

(4) There are additional alternatives which the United States could choose to strengthen Western energy security. ~~The U.S. is in the process of strengthening its own energy security:~~ the President's move to decontrol oil has resulted in a dramatic drop in oil imports which has benefited all consuming nations; the size of the Strategic Petroleum Reserve has doubled in eight months; and nuclear power and Alaskan natural gas prospects have been given strong Presidential endorsement.

The U.S. could consider further actions which would require interagency approval before these ideas could be presented to the Europeans. Some of these would include deregulation of natural gas, more active stock build and the imposition of an oil import security fee. The U.S. could also explore with the Europeans ways to accelerate the already promising outlook for U.S. coal exports to Europe. In addition, the U.S. and others could appeal to the new government in Norway to expand its natural gas production and capacity and transport systems. Plans could be developed

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to assist Norway with recycling revenues into profitable long term sources of income so that its domestic economy is not adversely affected. The US could also discourage imports of long haul LNG to U.S. markets (for example, by applying a prohibitive import fee and/or a comparative fuel price test) and thereby induce some producers to reconsider their pricing decisions. European gas consumers would clearly benefit from such action. (Annex 4 goes into more detail on possible US action.)

(5) In the event that the pipeline proceeds, means must be found and put in place to reduce European vulnerability. The best defense against a politically motivated cut-off is to have convincing emergency precautions in place that can be readily activated. Some of these precautions would include larger oil and gas stocks, shut-in gas reserves in European fields which could be used in a gas emergency, and more dual-fired capacity among large industrial users and electrical power plants--so that oil and coal could be substituted in the event of a disruption of the gas supply. There are several means to "internalize" the security costs (e.g., a gas import security fee) which could be used to finance security initiatives such as those described above. Such suggestions to the Europeans must be accompanied with convincing arguments for the need and preliminary assessments of the costs of these security measures. (Annex 2 has a fuller discussion of European vulnerability.)

(6) If it wished the US could try to <sup>complicate</sup> ~~delay~~ construction of the pipeline by seeking a joint US/UK embargo of key compressor components and technology for the project. Current plans for the pipeline call for west European compressor component manufacturers to procure compressor turbine rotors and drive shafts from General Electric. Only Rolls Royce now produces a turbine which is not based on U.S. technology and Rolls Royce is now prepared to deliver these key components. If we can obtain and effectively enforce a US-UK embargo of turbines to run the pipeline compressors, we may be able to <sup>delay</sup> ~~delay~~ the delivery of key components for ~~up to~~ two years. <sup>By that time</sup> a French licensee of G.E. technology could retool to produce a similar product. On the other hand, it is doubtful that the UK would go along with such an equipment embargo. (British Defense Minister Nott's reaction to Secretary Weinberger was very negative.) The US could also consider unilateral action. Such action would not be as effective as a joint US-UK embargo, but it would signal the seriousness of US concerns over the pipeline. U.S. companies would lose sales; GE, for example, would lose some \$175 million in sales and release a new competitor on world markets. Any other actions we might take are not likely to have the same impact in establishing the seriousness of our intentions.

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However, unilateral action is likely to meet with sharp European criticism and may weaken allied cooperation on other high Administration priorities. The motivation for such action will have to be clearly explained and understood because there could be charges that the US is unilaterally imposing its viewpoint on the Western alliance. If we choose to discuss the embargo option with the Europeans it will be necessary to develop a convincing argument to counter the likely European response that this is a move to punish Europe for going through with the deal. We should emphasize that such action is a worthwhile security measure and in long term Western security interests. Because such action could delay construction, it would give Europe more time to reassess the economic viability of the pipeline in light of recent and expected world energy markets. (See Annex V)

### Recommendations

(i) That the objectives and means outlined in this paper be cleared by members of the SIG on East-West Economic relations and, shortly thereafter, by a Cabinet level group (probably NSC).

(ii) That a high level State-led team visit Bonn, Paris, Rome and other selected capitals during the first week of November to present these ideas to the Europeans.

(iii) That subsequent to, and depending on the results of these meetings, a decision memorandum to the President be drawn up on whether or not an US/UK embargo on key compressor components and technology should be sought.

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ANNEX I - ECONOMICS OF THE SIBERIAN PIPELINE

The economics of the project are questionable:.

- Since 1978 the economic factors affecting East-West gas trade have changed dramatically. Overall energy growth rates are down and markets are soft. European gas demand fell last year by 4 percent. It appears that the rate of substitution of gas for oil has slowed. Official estimates of future gas demand have been revised downward and the market is likely to be weak for a considerable period of time.
- These fundamental changes in world energy markets raise serious questions as to whether the volume of gas contemplated for transmission through the pipeline can in fact find a market in Western Europe. While the Soviets may wish to set the FOB price as close as possible to the BTU equivalent of crude oil, in the current market and for the foreseeable future such a high price would almost certainly make it impossible for the gas to be competitive with other forms of energy in Western Europe.

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-- The volume of Soviet gas as a percentage of total European energy consumption is not alone a sufficient indicator of economic and political vulnerability:

- Gas is a difficult fuel to replace on short notice. Unlike oil, there is no spot market. Gas trade requires large start-up infrastructure investments in pipelines or LNG facilities. Furthermore, it is much more expensive and technically challenging to hold large strategic stocks of gas as compared to oil. Certain regions will be heavily dependent on Soviet gas and might apply strong pressure on national governments to avoid actions that could result in an interruption. In the event of an interruption, Soviet gas could not be readily replaced unless there was excess capacity in other parts of the European energy grid.

- Residential and commercial consumers are particularly dependent on gas. A cut-off of Soviet gas would be onerous for these politically sensitive sectors. Thirty percent of gas for the pipeline is earmarked for residential use. Residential and commercial consumers are the least able to absorb an abrupt fuel supply interruption. Homeowners have limited capacity to switch easily to another fuel. Furthermore, gas prices would probably rise precipitously in the wake of a Soviet embargo and thus place a harsh financial burden on homeowners and commercial businesses.

-- Technical or seasonal difficulties--perhaps complicated by the need to divert gas from export to domestic use to make up for reduced deliveries of Iranian gas--forced the Soviets to slow some gas shipments to the West last winter and spring. The probability of further technical or seasonal interruptions may increase as the Soviets try to ship more gas from outlying and more risky Siberian provinces to Western Europe.

-- In the past, the Soviet Union has used energy exports as a political lever, interrupting supplies to Yugoslavia, Israel, and China, among others. Under some circumstances, the Soviets might elicit otherwise unobtainable economic and political concessions from their West European gas customers.

-- Thus, West European vulnerability to Soviet gas leverage could be substantial. And it is not unreasonable to assume that the Soviets from time to time would see the dependence of Western Europe on Soviet gas as an opportunity to try to obtain political and/or economic benefits.

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# ANNEX III - ENERGY ALTERNATIVES AVAILABLE TO EUROPE

European economic security and political interests could be better served by choosing non-Soviet alternatives.

- A major alternative may be oil itself. The oil market for the 1980s has undergone a significant change from that of the late 1970s when plans for gas imports were developed. Few predicted the magnitude of demand reduction in response to rising oil prices. Much of this is due to structural changes in our economies and societies, not simply reduced economic growth. In light of these circumstances there is a possibility that energy prices may be relatively stable during the 1980s.
- African gas is closer to our European allies than it is to us and can be an alternative to Soviet imports. There are substantial gas resources in Algeria, Nigeria, Cameroon and Qatar that could be available to our European allies and friends; this gas could replace part of the anticipated Siberian pipeline deliveries.
- Within Western Europe, Norway has the potential to become an increasingly important gas supplier to Continental Europe in the 1990s, although prospects for accelerated development in the 1980s are uncertain. The US and others could assist Norway with recycling some of its increased revenues into long term profitable sources, so as to minimize the adverse short term effects in their economy. It may also be possible to convince the Dutch to slow their phase-out of exports in light of reduced demand. This is largely a political question, and could be influenced by our views.
- Coal has more potential than any other resource for providing additional energy during the rest of this century and beyond. Rapid growth in the use of coal is critical to the successful transition to a more secure energy future. There are increasing indications that a "coal renaissance" is now underway and that the shift to increased coal use will gain momentum.

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- The United States has taken and will continue to implement a number of steps which will increase the availability of oil as well as gas on the world market. We have already decontrolled oil prices in an effort to encourage domestic production and reduce wasteful use. Moves are also being taken to increase leasing of federal land including the Outer Continental Shelf in order to help stimulate heretofore locked-in domestic energy wealth.
- The Administration is currently reviewing proposals for accelerated gas price deregulation. But, even if the deregulation process cannot be accelerated, price controls on most domestic gas will be removed by the time that the Siberian pipeline is completed. Accelerated gas price deregulation will help stimulate domestic production and enable the US to decrease its need for ~~oil~~ and gas imports.
- As gas price deregulation proceeds, gas use will become more efficient and supplies more plentiful. To the extent the US will still require imported gas, market forces will favor imports from Canada and Mexico and possibly other Western Hemisphere sources rather than long-haul liquified natural gas (LNG). Even under our current competitive fuels test for the price of gas imports, long-haul LNG will have difficulty finding a place in the US market.
- The Administration has announced its commitment to the development of nuclear power in the US and has stressed that the US will reestablish itself as a reliable partner in the international nuclear energy arena. Many of our allies and friends in Europe will welcome the reentry of the US into a position of leadership in the international nuclear community. Several European countries are concerned about problems related to the back-end of the nuclear fuel cycle, specifically reprocessing and waste management. Our more positive position on reprocessing and expanded nuclear cooperation, particularly in the back-end of the fuel cycle, could help to mitigate some of the problems associated with the accelerated development of west European nuclear power.

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A means to possibly delay construction of the pipeline would be a US embargo of compressors and related technology. The supply of turbines may be a critical chokepoint for the West Siberian pipeline project. The Soviets have ordered some \$2 billion worth of turbine compressors for the project from Western European companies who are partial licensees of G.E. gas-turbine technology. Current plans call for General Electric (U.S.) to supply the European companies with \$175 million in critical turbine technology. GE and Rolls Royce control directly, or indirectly by means of licenses, all Western technology for the production of turbines that could be used on the pipeline. A French company, Alstrom-Atlantique, is the only full G.E. licensee of gas turbine technology, but does not now produce the type of rotor that G.E.'s partial licensees in Europe have ordered from the American company. Under the terms of the Export Administration Act, the President could place either national security or foreign policy export controls on this equipment and technology.

The US faces four options with regard to an embargo:

(i) No embargo. This would mean a continuation of present policy, as the US does not currently control the export of turbines or compressors nor their components and technology. This option would allow the construction of the pipeline to go forward as expected and US industry, in particular GE, would benefit. The perception that this would implicitly signal US approval is somewhat muted by the fact that no US company is a direct supplier. Other high Administration priorities in European dealings could continue to be judged on their own merit (as opposed to being possibly affected if an embargo option is chosen).

(ii) US unilateral embargo. This would signal the Europeans of the seriousness of US intentions. It would also deny the Soviet Union the best product; the GE turbine is known to them -- it is already in use and it fits their needs. If denied the GE product, the Soviet Union would likely purchase the more expensive UK Rolls Royce turbine: it is similar to the US technology, although it has not been tested in the Soviet Union. We recently learned that the British EGCD (their EXIM equivalent) is prepared to finance Rolls Royce -- thus the British Government appears ready to support such a sale. There is an added Soviet bonus to buying the Rolls Royce unit, since it is an aeroderivative engine several generations more advanced than the G.E. product.

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(iii) UK/US embargo. This option could have the effect of delaying delivery of compressor components for up to two years--the time needed for the French firm to produce a similar product. There is question now a delay in the components will affect the overall schedule of the pipeline completion.\* Compressors can be added rather late during construction and, therefore, gas flow might not be delayed significantly. UK Defense Minister Nott told Secretary Weinberger in August that the idea of UK participation in an equipment embargo is a "non-starter" and would be "politically disastrous" for the Atlantic Alliance because of German sensitivities over the project.

(iv) UK/US/French embargo. This option would have the most effect in delaying the pipeline. The Soviets would have to substitute two to three times as many of their compressors for the higher quality Western alternatives, if the Soviets could indeed increase production to that level. As noted above, there would be possibly serious problems in obtaining the British and French support for such action. While G.E.'s full licensee in France is technically bound by contract to honor US export control regulations, the US has no means to enforce this regulation outside of its borders. Enforcement would require French Government assistance and the French are unlikely to stop a project in which they have an important energy stake. Neither the French nor the British have domestic legal mechanisms to control trade that has not been designated as strategic (i.e., trade which has direct military application) by COCOM. COCOM, which operates on a consensus basis, does not currently control equipment and technology in the energy area, and a US proposal in COCOM to institute an embargo would face German (and perhaps other) opposition.

Since neither the British nor French have legislation with which to control non-strategic exports, a possible US alternative strategy with these countries is to ask them not to extend official credits for substitute sales to the USSR. All existing equipment orders for the pipeline, with the exception of GE sales of rotors to its European manufacturing associates, are slated to receive official credits. If Rolls Royce and Alsthom-Atlantique were forced to offer market financing for their substitute products, their attractiveness as suppliers would be diminished. However, as rotors constitute only about 10% of the total value of turbine and compressor sales for the pipeline, the Soviets might pay the price to ensure that the pipeline moves forward.

\*This issue is being carefully considered at this time and more information should be available shortly.

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If we choose to pursue one of the embargo options, a convincing strategy will have to be developed to counter the likely European view that this is a means to punish them for their decision to proceed with the pipeline. The US should stress that this is not the case: it is our sincere view that the embargo would serve an important Western security objective. Because such action might delay construction of the pipeline, the Europeans may reassess the economic viability of the pipeline, which in the view of the US has not been given sufficient attention in light of recent and expected world energy markets.

The decision to embargo is likely to affect other areas of European-US relations. It may also drive a wedge between the allies which would benefit the Soviet Union. The pros and cons of this action will have to be given careful consideration alongside other high Administration priorities.

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## ANNEX VI - LIKELY EUROPEAN REACTION TO US CONCERNS AND PRESENTATION

The Europeans are likely to reply that:

- Projected levels of European dependence on Soviet gas are low. Dependence on Soviet energy will be 5 percent or less of total energy consumption in all countries except Austria. The Europeans conclude, therefore, that the Soviets would not gain any real leverage as a result of this pipeline.
- Their use of Soviet gas is a necessary part of their strategy to reduce their oil consumption and to diversify their sources of energy. Soviet gas imports, by reducing their dependence on fuels from the Middle East, would, on balance, improve their overall energy security.
- The Soviet Union, unlike Middle Eastern suppliers, has never in the past shut off energy shipments to West European countries for political reasons.
- The only immediate alternatives to increased Soviet gas imports would be increased dependence on oil and gas from the least reliable Middle Eastern suppliers.
- They have scaled-down the project and are contemplating a safety net based on:
  - The flexibility of indigenous European gas production;
  - Their ability to substitute other fuels (oil or coal) for gas used in electric power plants and industry;
  - Significantly expanded stored gas reserves; and
  - The integration of European national gas grids.
- ~~The US approach does not meet one of the major reasons for proceeding with the project--the~~ creation of employment and contracts for the European companies, particularly in the currently depressed steel industry.

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Clearances:

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EUR/SOV:HHamilton  
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